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We are on course to stop a new financial crisis

By Barney Frank
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One year on from it being signed into law, the Wall Street Reform and Consumer Protection Act is on track to meet its promise. Critics attack the act, but it allows financial institutions to perform the vital function of accumulating capital and making it available to the productive elements in our society, while minimising the likelihood of irresponsible practices that contribute little to productive economic activity.

Given the magnitude of the crisis, why do some question legislation that lessens the chance of it happening again? The truth is that those who can no longer do things that they have found enormously profitable strenuously object when told to stop. Nonetheless, it is useful to respond directly. Critics say the bill is disruptive. Yet if it were not, it would not have been worth doing. The financial system had come up with ways to make lending risk appear to go away. The act forced lenders to take responsibility, and make those risks transparent. This discouraged inappropriate risks, and required the private sector (not taxpayers) to provide funds, in the form of more capital against retained risk, to cover liabilities.

It has also been claimed that the law is too long and complex. The problems in our financial system, however, were not isolated, but an interconnected system of loans improvidently made, inappropriately packaged, imprudently bought and inadequately capitalised. Passing a law that dealt with one or two of these aspects would have invited a new wave of financial engineering designed to obscure reality from investors and regulators.

Critics say the law does nothing to solve “too big to fail”. But it actually prohibits any federal official from spending money to keep a failing institution alive, and it also repeals the authority under which the US Federal Reserve loaned $85bn to AIG. The law stipulates that any funds spent to minimise the harm caused by the death of an institution are recovered by a levy on other large institutions without cost to taxpayers. And the argument, made by some, that being designated as “systemically important” confers advantages is conclusively rebutted by the fact that so many financial institutions have lobbied against being designated in this way.

On international competitiveness, it is true that there used to be a sense that countries seeking to preserve their financial services sectors ought to be deregulating, because only “light touch” schemes would be tolerated by the mobile international financial institutions. Fortunately, today, there is a recognition among international regulators that it is in our interest to create a strong framework with international co-operation, not a regulatory race to the bottom.

Domestically, critics accuse the legislation of restricting credit. Yet with one exception – residential mortgage loans to people who have no ability to repay them – the bill does not ban things. It sets rules. It requires lenders to retain some risk, while institutions must do due diligence on loans by limiting the role of rating agencies. It also extends regulation over a host of entities that are unregulated at the federal level – including mortgage lenders, cheque cashers, payday lenders and others.

The final accusation made is that the act gives too much discretion to regulators. This is the oddest of all. The alternative would have been to be overly specific: first by inviting scheming to get around rules that were too rigid, and second by imposing – for example – specific levels for such things as capital requirements, which must be adjusted as circumstances change.

At the turn of the 19th century, many business people complained about the adoption of antitrust laws that curtailed reckless practices. In the 1930s, many predicted a serious blow to American capitalism with the adoption of the Securities Exchange Act. Ten years from now, current objections to regulating derivatives and restricting imprudent residential mortgages will appear in the same light as these assaults on these earlier sensible reforms.

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